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David Line Batty

Jo Ann J. Brighton

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ARTICLES

"SILENT" SECOND LIENS - WILL BANKRUPTCY COURTS KEEP THE PEACE?

DAVID LINE BATTY[1] AND JO ANN J. BRIGHTON[2]

Over the past few years, a trend has developed to use financing secured by subordinated second liens, as an alternative to unsecured subordinated mezzanine financing, unsecured high yield debt, and other unsecured debt.[3] Second liens are also used to increase the overall size of a senior secured credit facility by differentiating between two classes of term loans within the same credit facility.[4] These liens are frequently referred to as "silent second liens" because the second lien holder has agreed to refrain from exercising rights and remedies against collateral - in other words, to remain "silent" - until the holders of the senior first lien are paid in full. Part I of this Article will briefly discuss the evolution of the second lien market, and Part II will discuss how bankruptcy considerations drive the key intercreditor terms of second liens. Part III will discuss the likelihood of enforceability of the "silence" provided for in the second lien documentation in a bankruptcy case. Finally, Part IV will conclude that the second lien market can benefit both lenders and borrowers.

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1. Mr. Batty is a partner with Kennedy Covington Lobdell & Hickman, L.L.P., Charlotte, North Carolina in the Financial Services Department - Banking and Finance Group where he practices primarily in the areas of syndicated lending, banking, and corporate finance.

2. Ms. Brighton is special counsel with Kennedy Covington Lobdell & Hickman, Charlotte, North Carolina in the Financial Services Department - Financial Restructuring Group where she practices primarily in the area of bankruptcy, workouts and secured lending. She is a contributing editor for the American Bankruptcy Institute Journal, serves on its Editorial Board, on the Advisory Board for the ABI Law Review, is certified in Business Bankruptcy by the American Board of Certification, and is a frequent author and lecturer on bankruptcy related topics.

3. *See* Howard Seife, *Silent Second Liens*, 121 BANKING L. J. 771, 772 (2004).

4. *Id.*

I. EVOLUTION OF THE SECOND LIEN MARKET

Companies have a variety of options for structuring financing in a way that provides the most benefits for their particular businesses. With the changes in the financial markets over the past several years, more creativity has been brought to bear than ever before. Economic downturns that lasted longer than originally anticipated caused cash flows and collateral values to fall drastically.[5] In response to escalating rates of default, lenders tightened credit polices and, for a time, leveraged cash flow lending essentially disappeared from the lending landscape.[6] The result of this credit crunch was that by 2003, many public and private companies were in a quandary as to how to refinance their debt as it matured.[7]

The syndicated loan market was further depressed throughout this period by the lack of demand for new debt from borrowers that were not forced to refinance because of an impending debt maturity.[8] As corporate profits suffered during the recent recession, non-investment grade merger and acquisition activity (a significant source of lending demand in any market) initially waned as private equity investors waited to see how far equity prices would fall.[9] Even after

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5. *See* Meredith Coffey, *Loan Market 2000: Defaults Rise, Angels Fall; Lenders Seek Safety in LowLeverage, Stolid Sectors*, GOLD SHEETS, Jan. 8, 2001, at 1 [hereinafter *Loan Market 2000*]; *see also* Meredith Coffey, *Cirque 2001: High-Grade Takes Center Ring, As Balance Sheets Turn and Borrowers Tumble*, GOLD SHEETS, Jan. 7, 2002, at 1 [hereinafter *Cirque 2001*]; *see also* Meredith Coffey, *Gravity's Rainbow? As Markets Tumble, Lending Slips But Angels' Fall is Leveraged's Redemption*, GOLD SHEETS, Jan. 6, 2003, at 1 [hereinafter *Gravity's Rainbow?*].

6. *See Loan Market 2000*, *supra* note 5, at 18-21; *see also Cirque 2001*, *supra* note 5, at 1 (following September 11, 2001, the "leveraged loan market collapsed").

7. *See Completing The Capital Structure With A Second Lien Loan*, CAPITALEYES (Bank of America Bus. Capital Monthly Newsletter), Apr. 2003, *at* http://www.bofabusinesscapital.com/resources/capeyes/a04-03-158.html (last visited Jan. 20, 2005) [hereinafter *Completing the Capital Structure*].

8. *See Cirque 2001*, *supra* note 5, at 1, 19; *see also Gravity's Rainbow?*, *supra* note 5, at 1, 18; Meredith Coffey, *From Bear Baiting to Bull Run: 12 Months of Fundamentals, Technicals - and Recovery*, GOLD SHEETS, Jan. 5, 2004, at 18 [hereinafter *From Bear Baiting to Bull Run*].

9. *See Cirque 2001*, *supra* note 5, at 19 (quoting Thompson Financial:

> U.S. merger activity fell by 57% from 2000 levels, and loans backing M&A tumbled by one-third to only $146 billion. Unsurprisingly, the leveraged sector was hard hit, with M&A lending falling more than 40%. Within the leveraged segment, LBO activity was even harder hit: Less than $13 billion come from that sector, leaving financial sponsors sitting on considerable war chests, but with few deals.).

purchase prices sunk to levels that encouraged buyers to re-enter the market, these buyers found lenders unwilling to finance acquisitions with high levels of total debt.[10] Instead, lenders insisted on seeing more equity dollars invested in the deal.[11] Faced with the prospect of putting more of their own funds in the game, private equity groups became even more critical of new deals and sought creative solutions to finance quality deals.[12]

One solution which emerged during this period was a traditional asset based loan in conjunction with a second lien financing. This approach succeeded because the tight credit policies and asset based approach of senior lenders prior to 2003 meant that collateral frequently had considerable value in excess of that needed to ensure that the senior lenders would be paid in full.[13] Borrowers and lenders used second liens to unlock the value of this "excess" collateral and provide much needed liquidity. Although second liens loans were offered at interest rates in excess of the then current senior debt market (to reflect the increased risk to the second lien position), these rates were far below what had been demanded for unsecured subordinated mezzanine debt, and by the fourth quarter of 2003, second lien debt was being used not only to solve liquidity problems but also to replace subordinated mezzanine debt in typical leveraged buy-out transactions.[14] In short, the pricing of second lien loans hit the sweet spot by appealing to lenders and borrowers alike.

See also Gravity's Rainbow?, *supra* note 5, at 1, 19; *see also From Bear Baiting to Bull Run*, *supra* note 8, at 18.

10. *See* Sadaf Khan, *More attractive assets, easier financing facilitate mid-cap LBOs reload*, GOLD SHEETS, June 2, 2003, at 1, 22 [hereinafter *LBOs reload*] (noting that "[l]ender wariness has translated into conservative deal structures for sponsored credits, with the average maximum total debt to EBITDA covenant restricted to 4.28 times. This is just a hair's breadth higher than 2002's 4.4 times, but far more restrictive than 1999's 5.11 times average.").

11. *See id.* (stating that "[l]enders' demands are similar to, if not more stringent than, their demands the past few quarters – high equity infusions, low leverage levels and high compensation in margin.").

12. *See id.* at 24 (stating that "[b]urned by a previous crop of deals, sponsor shops and lenders have become more cautious, placing more emphasis on due diligence than on return. So if there is an LBO surge, it is likely to be a muted one.").

13. Seife, *supra* note 3; *see also Cirque 2001*, *supra* note 5, at 18 (noting that "the best of deals are done in the worst of times").

14. STANDARD & POOR'S LEVERAGED COMMENTARY & DATA, SECOND-LIEN LOANS BLOSSOM; TREND LOOKS TO CONTINUE IN '04 (Dec. 2003) [hereinafter STANDARD & POOR'S 2003].

While second liens were initially used primarily to pay off existing debt or provide incremental liquidity, as corporations and lenders grew more comfortable with second lien financings, they came to be used in a broader range of circumstances.[15] The second lien market also grew as non-bank lenders such as hedge funds, specialized finance companies, and even subordinated mezzanine debt funds, were drawn to the structure by the relatively high margins offered on second lien debt.[16] Because these private investors are not regulated and are not constrained by internal credit risk ratings, they are free to look for true risk/return oriented structures and can review each potential deal on its own merits.[17] The familiarity lenders and borrowers gained with second lien structures in 2003, coupled with the relaxation of credit standards in response to a strengthening economy, drove a dramatic expansion of the second lien market from approximately $3.2 billion in all of 2003[18] to almost $12 billion[19] in 2004. In fact, second lien financings have become so popular that full collateral coverage for both the first and second lien debt no longer appears to be an absolute pre-condition of such financing. Accordingly, the creativity of lenders and borrowers alike has given birth to a new loan structure that is likely to be around for some time.

II. MECHANICS OF "SILENT" SECOND LIENS

A. *What Is a "Silent" Second Lien?*

The terms "first" lien and "second" lien are simply a shorthand

15. *Id.* (observing that lender willingness to use second lien financing in "mainstream" deal had replaced a more limited use of second lien financing as rescue financing for borrowers "facing liquidity problems"); *see Why Today's Borrowers and Investors are Leaning Toward Second Liens*, CAPITALEYES (Bank of America Bus. Capital Newsletter), Feb., 2004, *at* http://www.bofabusinesscapital.com/resources/capeyes/a02-04-210.html (last visited Jan. 20, 2005) [hereinafter *Toward Second Liens*].

16. STANDARD & POOR'S 2003, *supra* note 14.

17. *Toward Second Liens*, *supra* note 15.

18. STANDARD & POOR'S 2003, *supra* note 14. *But see* STANDARD & POOR'S LEVERAGED COMMENTARY & DATA, A VERY GOOD YEAR: 2004 LEVERAGED LENDING, BY THE NUMBERS (Dec. 2004) (noting that the volume of second lien financing declined throughout the course of 2004) [hereinafter STANDARD & POOR'S 2004]; Christopher J. Rockers & Christine Gould Hamm, *Exploring the Possibilities for No. 2: All about second lien loans*, 14 Bus. L. Today 35 (Jan./Feb. 2005).

19. Standard & Poor's 2004, *supra* note 18; *see also* Rockers & Hamm, *supra* note 18.

way to describe the relative priority of two separate liens on the same collateral. The relative priorities could simply be the result of the time or method of perfection of the lien,[20] or the result of the express agreement of the parties. In the second lien financings discussed in this Article, the second lien ranks junior to the first lien because the second lien holders have contractually agreed to subordinate their rights and remedies with respect to the collateral to the rights and remedies of the first lien holders until the debt secured by the first lien is paid in full.[21] The scope of this lien subordination is narrower than debt subordination, because subordinated debt generally does not receive any payment until the senior debt has been paid in full.[22] The significance of this distinction becomes apparent if the proceeds of the collateral are insufficient to pay off the senior debt in full. If the senior debt benefits from debt subordination, the benefits of subordination will continue notwithstanding the collateral shortfall. Conversely, if the senior debt only benefits from lien subordination, that subordination ends the moment the collateral runs out. Once the collateral has been fully liquidated, both the first lien and second lien holders become unsecured creditors and their claims will rank *pari passu*.

Generally, secured second liens are structured one of two ways. The most common structure is for the first lien to be secured by all the available assets and the second lien to rely on incremental dollars against the same collateral pool – very similar in concept to a second mortgage on a home. In a typical second lien transaction, a bank or other lender (or a lending group) takes a first lien on all or substantially all of a borrower's assets. The debt may or may not be guaranteed by

20. *See, e.g.* U.C.C. § 9-322 (2001).

21. In the current market, second lien financing tends to either be in the form of term loan held by institutional investors in the context of a syndicated credit facility or a high-yield debt issuance. *See* Neil Cummings & Kirk Davenport, *How to Structure U.S. Second Lien Financings*, I.F.L.R. (Latham & Watkins, New York, N.Y. & L.A., Cal.), June 2004, at 26, *available at* http://www.lw.com/resource/publications/_pdf/pub998_1.pdf [last visited Jan. 20, 2005]. Typically, the intercreditor provisions governing a second lien term loan are more heavily negotiated by the second lien holders than the intercreditor provisions of second lien high yield offerings. *See id.* at 27 ("second lien bond deals tend to be more silent than second lien term loan deals").

22. The scope of debt subordination terms frequently vary depending on the type of debt involved. In fact, many types of subordinated debt are permitted to receive some payments (usually current interest) prior to the payment in full of the senior debt, as long as no default has occurred and is continuing under the senior debt. *See* Cummings & Davenport, *supra* note 21, at 26.

affiliated companies or additionally secured by their assets, and the borrower generally has other creditors such as trade or general unsecured creditors.[23] Another lender (or another lending group), consortium, hedge fund, bond group or other investors (acting for itself or for public or private capital markets) then extends credit to the same borrower, taking a second lien on all or substantially all of the assets upon which the first secured creditor has a lien.[24]

The second, less common, structure is for the first and second liens to be secured by different pools of collateral. For example, one loan is secured by receivables and inventory and another uses the fixed assets such as property, plant and equipment for collateral.[25] The types of collateral are varied and can encompass any type of collateral traditionally used to secure an asset based loan.[26]

B. Bankruptcy Considerations Which Drive the Terms of Lien Subordination

A second lien is described as "silent" when the second lien holder contractually agrees to subordinate many of the rights it has as a secured creditor upon an event of default or in the event of a bankruptcy case commenced by, or against, the borrower to the first lien holder.[27] The terms of this contractual subordination are typically reflected in an intercreditor agreement, which will also include terms that govern the relationship of the first lien and second lien holders prior to default.[28]

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23. *See* Seife, *supra* note 3, at 772.
24. *Id.*
25. *Completing the Capital Structure*, *supra* note 7.
26. *Id.*
27. An example of such a subordination provision is as follows:

> To the extent that the [Prepetition Junior Lender] has or acquires any rights under Section 363 or Section 364 of the Code (as defined below) with respect to the Collateral, the [Prepetition Junior Lender] hereby agrees not to assert such rights without the prior written consent of the [Prepetition Senior Lender], provided that, if requested by the [Prepetition Senior Lender], the [Prepetition Junior Lender] shall seek to exercise such rights in the manner requested by the [Prepetition Senior Lender].

28. Because second lien financings are still a relatively recent development, there is not yet broad consensus on all aspects of these intercreditor agreements. *See* Kirk Davenport, *The Silence of the Liens*, N.Y. L.J., Jul. 9, 2004. ("second lien . . . markets are still making and we have not reached the point where there is a standard checklist of 'market' intercreditor terms"). Because second lien loans tend to have the most highly negotiated

The central characteristic of any contractual subordination agreement (whether debt subordination or lien subordination) is that the senior lender will want to ensure that its rights and remedies are as free from interference by the subordinated lender as possible.[29] Additionally, the senior lender will want the ability to exercise control over the actions of the subordinated lenders. Conversely, subordinated lenders seek to limit the control of the senior lender, as well as to obtain limits over actions of the senior lenders that have the effect of "deepening" the terms of subordination in effect at closing. The essence of the negotiation of subordination terms is to strike a balance between these competing goals. When second lien financings first gained hold, the balance tended to be skewed in favor of the first lien holder. More recently, as second lien holders have gained more experience with the subordinated lien structure, the balance has moved in the direction of the second lien holder.

Consistent with the first lien holder's desire to control its own destiny, typical second lien intercreditor agreements will require the second lien holder to release its second lien on the collateral whenever the first lien holder has elected to release the first lien on such collateral pursuant to the terms of the first lien loan documents. Although this provision is fairly broadly drafted in favor of the first lien holder, there are some limits. For example, the first lien holder is usually not permitted to release all of the collateral without the consent of the second lien holder. The first lien holder will also seek to control the terms of the second lien collateral documents, specifically, the right to approve any modifications to the documents evidencing the creation and governing the terms of the second lien. At a minimum, the first lien holder will <u>usually insist</u> on the right to approve modifications which are adverse or otherwise inconsistent with the agreed upon priority of the first lien relative to the second lien. Furthermore, the first lien holder will strive to preserve the status quo by requiring provisions that prohibit the second lien holder from challenging the priority of the first

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intercreditor agreements, this discussion of intercreditor provisions in this Article focuses on the intercreditor provisions applicable to second lien term loans. *See* Cummings & Davenport, *supra* note 21.

29. *See* Cummings & Davenport, *supra* note 21, at 26 (stating that first lien holders protect their interest through a "lien subordination agreement that strips the second lien creditors of most of the rights they might otherwise exercise to the detriment of the first lien creditors").

lien or from taking a lien on any assets that do not also secure the first lien debt. As the purpose of these provisions is to ensure that the second lien holder cannot attempt to modify the deal to the detriment of the first lien holder after closing, these provisions are typically acceptable to the second lien holder.

The desire to preserve the status quo works both ways, however. At the time of closing, a second lien holder can readily determine the amount of debt that will be secured by prior liens. To the extent that the amount of debt secured by a first lien increases, the likelihood that the collateral can support a full recovery by the second lien holders diminishes. Therefore, the second lien holder will insist upon restrictions on the amount of additional first lien debt. Although it is in the interest of all parties to provide some incremental first lien availability,[30] the first lien holder will typically agree to some outside limit on the amount of debt that can be secured by the first lien without the consent of the second lien holder.

The foregoing provisions all govern issues that are reasonably likely to arise during the ordinary course of a performing loan transaction. The real action, of course, arises when things do not go according to plan. Given the high leverage of transactions involving silent second liens, a nonperforming borrower is likely to be left in a position where bankruptcy protection may be the only option. Therefore, it is also necessary for the first lien and second lien holders to anticipate the effect of a bankruptcy proceeding on their intercreditor agreement when negotiating the subordination terms.[31]

1. Subordination of Remedies

The heart of any second lien intercreditor agreement is the specific agreement of the second lien holders to subordinate their right

30. Because of the existing lending relationship between the borrower and the first lien holders, additional first lien debt can frequently be obtained quickly and less expensively than new debt. These factors can be critically important if the borrower needs additional liquidity to fund a strategic acquisition, for example. Similarly, existing first lien holders are often the best source of an incremental amount of "workout" financing that may allow the borrower to weather a short downturn in performance that could be magnified into a larger problem without such additional liquidity.

31. *See infra* Part III.B. (discussing and analyzing the enforceability of the critical terms of contractual lien subordination).

to exercise remedies with respect to the collateral until the payment in full of the first lien debt. The exclusive right of the first lien holder to exercise foreclosure and other rights upon default is, in fact, the hallmark of the "silent" second lien financing structure. In the initial phases of the second lien market, first lien holders insisted upon and received unlimited "blockage periods"[32] during which the second lien holders were required to sit silently on their rights and remedies whether or not the first lien holders were actively pursuing their rights and remedies with respect to the common collateral. As the second lien market has evolved, however, second lien holders have pushed back on this one-sided approach. Now, the more common approach is for the duration of the remedy blockage to be limited to a finite number of days during which the first lien holder must initiate action or lose its exclusive right to proceed against the common collateral.[33]

In addition to demanding the exclusive right to exercise remedies with respect to the collateral, the first lien holders do not want the second lien holders to second guess the manner in which the first lien holders exercise their rights. To protect the finality of the enforcement and foreclosure actions of the first lien holders, the second lien holders are generally precluded from challenging or objecting to these actions.[34] Anything short of such prohibition leaves the first lien holder open to collateral attack by the second lien holder if the proceeds

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32. *See* Rocker & Hamm, *supra* note 18, *at* 36 (labeling this waiting period the standstill period).

33. Because virtually all non-insider debt subordination agreements include a similar limit on the duration of the remedy blockage period, it is not surprising that the second lien subordination market has moved in the same direction. Although a duration of one-hundred and eighty (180) days is a good benchmark for the minimum duration of the remedy standstill period, the length of the remedy standstill is often subject to intense negotiation and the consensus on this point is still evolving. Furthermore, as the expiration of the blockage period will force the first lien holder to initiate action or risk losing its exclusive right to act, the borrower has an interest in seeing a longer blockage period.

34. On this front, Article 9 of the Uniform Commercial Code comes to the aid of the second lien holders. More specifically, Section 9-602 of the UCC provides that the following obligations imposed upon the first lien holder may not be waived: Section 9-611 (requiring notification to junior lienholders before disposing of collateral) and Section 9-610(b) (requiring commercial reasonableness in disposing of collateral). Additionally, the right of a senior secured party to strict foreclosure of the collateral is subject to the right of a subordinated secured party's right to object to such remedy. *See* U.C.C. § 9-620 (2001). A senior secured party can be liable for damages to a subordinate secured party for breach of the obligations imposed on such senior secured party under Article 9 of the UCC. *See* U.C.C. § 9-625 (2001).

of the collateral are insufficient to satisfy both the first lien and second lien claims.

2. First Lien Holder's Right to Seek Relief from the Automatic Stay

When a borrower files a petition for relief under the United States Bankruptcy Code (the Bankruptcy Code),[35] a stay springs into place (commonly referred to as the "automatic stay") which bars any creditor from taking any action against the debtor, or any property of the debtor, which is designed to afford the debtor "breathing room" from creditor pressure to give a debtor time to formulate a plan of reorganization or orderly liquidation.[36] A creditor can request relief from the automatic stay to exercise its rights and remedies against a debtor, or property of the debtor, if it can demonstrate, *inter alia* that "cause" exists to grant such relief.[37]

First lien holders want the flexibility to lift the automatic stay without the interference of the second lien holders to permit the piecemeal foreclosure on specific items of collateral if necessary. Thus, the first lien holder will negotiate for an intercreditor agreement that includes an advance waiver by the second lien holder of its right to contest any lifting of the stay requested by the first lien holder. Although second lien holder might object to providing such advance waiver due to the possibility that a collateral sale will not be done to protect the residual value of the collateral, this objection will almost certainly be rejected by the first lien holder.

3. Financing the Debtor's Operations Following the Commencement of a Bankruptcy Proceeding

In a bankruptcy case, a debtor can use cash which is otherwise pledged as collateral to its lender, if certain requirements are met under the Bankruptcy Code and the bankruptcy court enters an order approving the use of such "cash collateral."[38] Further, a debtor may obtain additional financing post-petition which allows the debtor to

35. 11 U.S.C. § 101 *et seq.* (2001).
36. 11 U.S.C. §§ 362, 541 (2001).
37. *See* 11 U.S.C. §§ 362, 363 (2001).
38. 11 U.S.C. § 361 (2001).

continue operations and funds the financial needs of the debtor pending the approval of a plan of reorganization or liquidation (debtor in possession or DIP financing).[39] Therefore, following the filing of a bankruptcy petition, the very next filings are typically cash collateral and DIP financing motions to enable the debtor to fund the continuing operations after the commencement of a bankruptcy proceeding. The financing takes the form of a DIP Financing Order. The lender or lenders providing such DIP financing will get a super-priority "priming" lien on collateral senior to other secured lenders, including the prepetition first lien loans and second lien loans. To obtain this priming lien, as well as to use the cash collateral, the debtor must show that those other secured creditors are "adequately protected" – i.e., that such secured creditors will not suffer loss of collateral value while a borrower is in bankruptcy and that the financing could not be obtained from any other source on any more favorable terms.[40]

To protect its position and maintain control of the process, the first lien holder will often want to provide the DIP financing as well as control the use of cash collateral. Therefore, first lien holders have historically insisted on restrictions on the ability of the second lien holders to argue that they are not adequately protected or to otherwise disrupt the first lien holder's control of the process (such as by submitting a competing DIP financing motion).[41] Consistent with the evolution of the second lien market discussed elsewhere in this Article, second lien holders have increasingly rejected absolute restrictions on their right to adequate protection. After a period of accepting limitations that ensured that second lien holders would not interfere with DIP financings supported by the first lien holders, many second lien holders now seek to retain their general rights to adequate protection. This area continues to be unsettled, and the overall

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39. 11 U.S.C. § 364 (2001).

40. 11 U.S.C. §§ 361, 363, 364.

41. An example of such agreement is as follows:

> The [Prepetition Junior Lender] hereby consents to the extension of debtor-in-possession financing by one or more of the [Prepetition Senior Lenders] pursuant to 11 U.S.C. 101 et seq. (the "Code") and the use of the [Prepetition Senior Lenders'] cash collateral pursuant to the Code, and to the granting of super priority administrative claims and liens senior to the liens of the [Prepetition Senior Lenders] in the Collateral.

enforceability of the adequate protection waivers is discussed below.[42]

4. The Importance of Post-Petition Interest

Interest that would accrue after a filing of a bankruptcy petition is commonly referred to as "post-petition interest." Depending on the size of the loan, and the length of the bankruptcy case, post-petition interest can easily grow into a significant claim in bankruptcy. The Bankruptcy Code provides that interest can be paid currently during the bankruptcy proceeding to secured creditors so long as certain criteria are satisfied.[43] For a creditor to be allowed post-petition interest, the bankruptcy court must find that the value of the collateral exceeds the amount of the claim of such creditor – in other words, that the creditor is "oversecured."[44] Obviously, the inclusion of both the first liens and the second liens in same class of creditors would require the collateral pool to cover both the first lien claims and the second lien claims (not just the first lien claims) for a bankruptcy court to determine that such creditors are oversecured.[45]

To support a finding that the first lien and second lien debt are separate classes of claims, the first lien holder should require that the intercreditor agreement include an express statement that the first lien and second lien claims are distinct claims as well as an express agreement that such claims will be classified as separate claims in a bankruptcy proceeding.[46] Additionally, having separate loan documents (and separate agents in syndicated transactions) enhances the argument that the first lien claims and the second lien claims should be classified separately. That is one reason why second lien transactions typically include two sets of separate loan and collateral documents.

42. *See infra* Part III.B.1-2.

43. 11 U.S.C. § 506(b) (2001).

44. *Id.*

45. *See infra* Part III.B.3. The payment of post-petition interest may also be limited by the Rule of Explicitness and a recent decision issued by the First Circuit. *Id.*

46. *See* Rockers & Hamm, *supra* note 18, at 37 (citing the case of *In re* Ionosphere Clubs, Inc., 134 B.R. 528 (Bankr. S.D.N.Y. 1991) as an example of the importance of the intercreditor agreement expressly stating distinct first and second lien claims); In re Ionosphere Clubs Inc., 134 B.R. 528 (Bankr. S.D.N.Y. 1991) (holding that the creditor with first priority was not oversecured, and thus was not entitled to post-petition interest, because all of the debt held by three separate creditors constituted only one grant of a security interest and, thus, one claim).

Collectively, these factors have the effect of increasing the likelihood that the first lien holders will be able to demonstrate that the collateral is sufficient to oversecure their claim, as well as to support separate classification for purposes of voting rights regarding reorganization plans.

5. The Use of Voting Restrictions, Waivers, and Agreements by the First Lien Holders to Control the Plan Confirmation Process

For a debtor to exit Chapter 11, it must submit either a plan of reorganization or liquidation which complies with requirements set forth in the Bankruptcy Code.[47] Similarly situated creditors are placed in "classes" separate from other creditors that are not similarly situated.[48] For a plan to be confirmed it must receive the affirmative vote of more than two-thirds in amount and greater than fifty percent in number of the allowed claims of such class held by creditors (subject to good faith voting requirements).[49] To ensure that the first lien holders control the plan confirmation process, first lien holders generally want the second lien holders to agree to support a reorganization plan in a bankruptcy proceeding supported by the first lien holders. Otherwise the second lien lender could block the confirmation of any plan. Therefore, the intercreditor agreement will include restrictions on the rights of the second lien holder with respect to voting for plans of reorganization.[50] Because the first lien holder may not want to take the

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47. 11 U.S.C. §§ 1123, 1129 (2001).
48. 11 U.S.C. § 1122 (2001).
49. 11 U.S.C. § 1126(c) (2001).
50. An example of such voting restrictions is as follows:

> Upon the occurrence of any Insolvency Event, the [Prepetition Junior Lender] acknowledges, agrees, authorizes and empowers irrevocably the [Prepetition Senior Lender] (in its own name or on behalf of the [Prepetition Junior Lender] to demand, sue for, collect and receive every payment of distribution made in respect of the [Prepetition Junior] Obligations to the extent out of Collateral, and to give acquittances therefore and to file claims and proof of claim and take such other action (including without limitation voting claims with respect to the [Prepetition Junior] Obligations or enforcing any lien securing payment of the [Prepetition Junior] Obligations) the [Prepetition Senior lenders] may deem necessary or advisable, from time to time, for the exercise or enforcement of any rights, interests or remedies hereunder with respect to the Collateral and may consent, on behalf of the [Prepetition Junior Lender], to subordinate the lien securing the [Prepetition Junior]

liability risk of actually voting the claims of the second lien holder, the first lien holder may instead require the second lien holder to support any plan proffered by the first lien holder.

It is rare for the second lien holder to fully waive its rights to vote in connection with a plan because the right to vote on a plan and to object to its confirmation provides very meaningful protections for a secured creditor. A full waiver of such rights may cause the second lien holder to have fewer rights than an unsecured lender and trade creditors (both of whom rarely if ever agree to limit their voting rights in a plan). The enforceability of voting waivers is in question and discussed below.[51]

A creditor with a "claim" must file a proof of claim with the bankruptcy court before a date set by the bankruptcy court - the bar date - in order to receive payment on the "claim."[52] Filing a proof of claim on or before the bar date is important to preserve rights to payment, as well as voting rights to any plan proposed by the debtor.[53] To ensure that the first lien holder does not lose the benefit of its ability to vote, or direct the vote of the second lien holders, the first lien holder will frequently require the ability to file proofs of claim on behalf of the second lien holder.

6. Other Bankruptcy Issues

Second lien holders also commonly waive (1) the right to oppose the sale of collateral in a § 363 sale (which is a sale of assets out of the ordinary course of business after the bankruptcy petition is filed and before a plan of reorganization is confirmed[54] or as part of a plan of reorganization) and (2) to contest the value of the sale of any collateral. Although these are common provisions in second lien intercreditor arrangements, they have the anomalous effect of taking away rights the second lien holder would have if it was unsecured. However, second lien holders have generally accepted such limitations in exchange for

Obligations to any financing referred to in clause (iv) above. Nothing herein shall obligate the [Prepetition Senior Lenders] to take any of such actions.

51. *See infra* Part III.B.4-5.

52. 11 U.S.C. §§ 101, 501 (2001); FED. R. BANKR. P. 3002, 3003.

53. 11 U.S.C. § 1126 (2001); FED. R. BANKR. P. 3018.

54. 11 U.S.C. § 363 (2001).

the benefit of obtaining priority over unsecured creditors.

7. Benefits of a Second Lien Position in Bankruptcy

As discussed above, in order to obtain the consent of the first lien holders to permit the second lien to exist, the second lien holders are required to become "silent" by agreeing to the following general terms:

- waiver of right to object to validity, priority or enforceability of the first lien holder's position;
- consent to the first lien holder's rights to receive all proceeds from the collateral until the first lien debt is paid in full;
- advance waiver of objections to DIP financings if requested or approved by the first lien holder;
- agreement to abide by the first lien holder's positions with respect to adequate protection, use of cash collateral, sale of assets and relief from stay;
- agreement to waive or limit rights to freely vote on any plan of reorganization and agreement not to vote in favor of any plan opposed by the first lien holder; or, in the alternative, an assignment of the second lien holder's right to vote to the senior lien holder.[55]

Despite these consensual limitations, silent second liens are attractive to junior lenders because such security affords the second lien holders the prospect of a greater recovery than unsecured lenders and also gives the second lien holders certain significant rights (subject to the limitations of the agreed upon lien subordination) as secured creditors in bankruptcy. These rights include adequate protection; claims for post-petition interest; the right to consent to, or object to,

55. Seife, *supra* note 3, at 774.

extensions of credit to a debtor in possession that prime prepetition liens; the right to be heard on the use of collateral and the sale of collateral by the debtor in possession; and the right to be placed in a separate class in a reorganization plan. Collectively, the rights of a secured party in bankruptcy are significant, and historically secured creditors have had much higher recovery rates than unsecured creditors.[56] Nevertheless, because second lien holders bear a higher level of risk (vis-à-vis the first lien holders) of the failure of repayment, they are entitled to a higher rate of interest than the first lien holders. As evidenced by the explosion of second liens in the past year, these higher rates of interest are the factor that has most likely attracted so many investors to the second lien market.[57]

III. CAN, OR WILL, BANKRUPTCY COURTS KEEP THE PEACE?

Quite simply, first lien holders would not agree to permit a second lien without the protections afforded by an intercreditor agreement including the provisions discussed above.[58] In exchange for agreeing to such intercreditor arrangements, the second lien holders are permitted to take their lien and they are paid a higher rate of interest by the borrower on their loan. In sum, the basis of the bargain for the second lien structure is the enforceability of the intercreditor agreement. Therefore, the critical question is: are the terms of such agreements enforceable in bankruptcy?

A. *General Enforceability of Agreements to Subordinate Payment*

Congress has acknowledged the validity of subordination agreements in § 510(a) of the Bankruptcy Code, which provides:

> (a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

Section 510(a) codified the pre-1978 Bankruptcy Act holding of

56. *See* Cummings & Davenport, *supra* note 21, at 27.
57. *See* STANDARD & POOR'S 2003, *supra* note 14.
58. *See supra* Part II.B.

In re Credit Industrial Corp.,[59] which stated: "A bankruptcy court, in order to effectuate its duty to do equity, must enforce lawful subordination agreements according to their terms and prevent junior creditors from receiving funds where they have 'explicitly agreed not to accept them'" and "subordination agreements are almost uniformly enforced by the bankruptcy courts."[60] Soon after the adoption of the Bankruptcy Code in 1978, a Minnesota bankruptcy court restated the position on prepetition subordination in the *Hart Ski*[61] case:

> The intent of § 510(a) (subordination) is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceeding. There is no indication that Congress intended to allow creditors to alter by a subordination agreement, the bankruptcy laws unrelated to distribution of assets.[62]

Payment subordination is, therefore, acknowledged and enforced in the bankruptcy courts.

B. Enforceability of Intercreditor Agreements Extending Beyond Payment Subordination

The established enforcement of subordination in bankruptcy courts is subordination with respect to payment priority and not necessarily with respect to the subordination of rights and remedies. Whether bankruptcy courts will, or even can, enforce waivers contained in subordination agreements concerning the exercise of the junior creditor's rights and remedies is unclear, at best. There has long been debate concerning the enforceability of waivers obtained by lenders from debtors prepetition concerning the waiver of certain rights after a bankruptcy petition is filed. In those cases, courts have been very

59. 366 F.2d 402 (2d Cir. 1966).

60. *Id.* at 408, 410 (citing Elias v. Clarke, 143 F.2d 640 (2d Cir. 1944), *cert. denied*, 323 U.S. 778, 65 S.Ct. 191, 89 L.Ed. 622 (1944); *In re* Aktiebolaget Krueger & Toll, 96 F.2d 768 (2d Cir. 1938); *cf.* Prudential Realization Corp. v. Geist, 316 U.S. 89, 97, 62 S.Ct. 978, 86 L.Ed. 1293 (1942)).

61. *In re* Hart Ski Mfg. Co., 5 B.R. 734 (Bankr. D. Minn. 1980).

62. *Id; see also In re* Ionosphere Clubs, Inc., 134 B.R. 528 (Bankr. S.D.N.Y. 1991).

reluctant to enforce any waivers agreed to in advance of a bankruptcy filing by a borrower and have determined, that, barring exigent circumstances, such waivers are generally not enforceable.[63] When looking at whether bankruptcy courts will enforce such waivers when agreed to in advance by sophisticated lenders, it certainly can be argued that the analysis is very different and it is not necessary for the bankruptcy court to play such a protective role. However, a strong argument can also be made that parties, no matter how sophisticated, should not be able to contract away statutorily afforded rights provided by the Bankruptcy Code and essentially override the priority scheme of the Bankruptcy Code sets forth.

Nevertheless, different courts in different locations have reviewed the issues concerning the enforceability of waivers by second lien holders of rights to adequate protection, to contest DIP financing and cash collateral orders, to object to the payment of post-petition interest to senior creditors, to vote on plans of reorganization and other similar waivers, and the decisions have yielded differing results. Accordingly, no definitive answer as to the enforceability of these prepetition waivers, consents and agreements has yet been established.

1. Adequate Protection and the Automatic Stay

In the *Hart Ski* case, the senior creditor sought the assistance of the bankruptcy court to prevent the junior creditor from seeking adequate protection or the lifting of the automatic stay based on language in the subordination agreement, which, according to the senior creditor, deprived the junior creditor from exercising such rights.[64] The bankruptcy court refused to enforce the provisions at issue and held that Congress never intended that parties could alter by subordination agreement the bankruptcy laws unrelated to distribution.[65] Specifically, the court noted that the Bankruptcy Code guarantees each creditor rights regardless of subordination and reasoned:

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63. *See, e.g.*, *In re* Shady Grove Tech Center Assoc. Ltd., 216 B.R. 386 (Bankr. D. Md. 1998) *opinion supplemented*, 227 B.R. 422 (Bankr. D. Md. 1998); *see also In re* Powers, 170 B.R. 480 (Bankr. D. Mass. 1994) (holding that prepetition agreements waiving opposition to relief from stay may be enforceable in appropriate cases); *In re* Pease, 195 B.R. 431 (Bankr. D. Neb. 1996); *In re* Desai, 282 B.R. 527 (Bankr. M.D. Ga. 2002).

64. 5 B.R. at 734 (Bankr. D. Minn. 1980).

65. *Id.* at 736.

> These rights include: The right to assert and prove its claim, the right to seek court-order protection for its security, the right to have a stay lifted under proper circumstances, the right to participate in the voting for confirmation or rejection of any plan of reorganization, the right to object to confirmation and the right to file a plan where applicable . . . [these] rights and others not related to contract priority of distributions pursuant to Section 510(a) cannot be affected by the actions of the parties prior to the commencement of a bankruptcy case when such rights did not even exist. To hold that as a result of subordination agreement the 'subordinor' gives up all its rights to the 'subordinee would be totally inequitable.[66]

Nineteen years later, *In re Hinderliter Technologies, Inc.*,[67] another bankruptcy court specifically noted "[s]ubsequent case law does not significantly diverge from the *Credit* and [*Hart Ski*] Court's holdings."[68] Accordingly, the statements of the *Hart Ski* court remain troublesome for those seeking to enforce provisions of silent second liens regarding adequate protection and the automatic stay in bankruptcy court.

2. DIP and Cash Collateral Issues

More recently, in a case in the Middle District of Pennsylvania, *New World Pasta*,[69] objections were filed by junior lien holders to the motions requesting approval of the DIP financing, the use of cash collateral and the adequate protection finding (the "Objections"). In the Objections, the junior lien holders acknowledged that the debtor needed the post-petition financing on a super-priority basis, but requested that the court strike certain provisions as "offending language" since, in the objecting creditors' opinion, such language "potentially deprives the

66. *Id.*
67. 228 B.R. 848 (Bankr. E.D. Tex. 1999).
68. *Id.*
69. *In re* New World Pasta, No. 04-02817 (M.D. Pa. filed May 10, 2004).

Prepetition Junior Lenders of fundamental bankruptcy rights and protections that cannot be traded away in prepetition agreements to the extent that [such agreements] purport to do so."[70] The "offending language" specifically sought a waiver from the prepetition junior lenders of the rights to adequate protection and to vote on the Chapter 11 plan.[71] The Objections acknowledged the cases cited in this article and argued that any order approving the DIP financing and authorizing cash collateral should not be used to obtain declaratory or injunctive relief on these unsettled issues of the enforceability of waiver provisions by junior lien holders in bankruptcy cases.[72] The Objections further argued that the enforceability of the "offending language" can only be properly decided as part of an adversary proceeding.[73]

The *New World* court issued a final order approving the DIP financing, the use of cash collateral, and the adequate protection finding (the "Order").[74] The Order specifically approved the subordination of payment of the junior creditors to the senior creditors.[75] However, the Final Order did tone down the "offending language" which originally provided:

> The rights and remedies of the Prepetition Junior Lenders with respect to the Subordinate Obligations, if any, shall only be exercised in a manner consistent with and subject to the Prepetition Credit Agreement and Prepetition Participation Agreements.

The Final Order replaced that language with the following:

> 38. <u>Prepetition Participation Agreement</u>. Notwithstanding anything in this Order to the contrary, the Prepetition Participation Agreements

70. *See* 2004 WL 1484987 at *2.
71. *Id.* at 3.
72. *Id.*
73. *Id.*
74. *In re* New World Pasta, No. 04-02817 (M.D. Pa. filed May 10, 2004) (issuing Final Order Authorizing (A) Secured Postpetition Financing on a Super Priority Basis Pursuant to 11 U.S.C. § 364, (B) Use of Cash Collateral Pursuant to 11 U.S.C. § 363, and (C) Grant of Adequate Protection Pursuant to 11 U.S.C. §§ 363 and 364, entered July 9, 2004.).
75. *Id.* at 9, 25-26.

> are in full force and effect and nothing herein shall alter, modify, amend or effect the terms and conditions of the Prepetition Participation Agreements, and nothing herein is or shall be deemed a waiver of any rights or remedies of the Prepetition Agent or Prepetition Senior Lenders thereunder. Nothing in this order shall be deemed to alter, amend, prejudice or waive the rights of the Prepetition Senior Lenders or the Prepetition Junior Lenders with respect to the Subordinate Obligations under the Prepetition Credit Agreement and the Prepetition Participation Agreements, provided, however, that in the event a court of appropriate jurisdiction finds that the Prepetition Junior Lenders' and/or JLL's agreements and waivers contained in the Prepetition Agent preserves its rights to enforce such agreements and waivers retroactively to the Petition Date, including revoking any protections previously granted to the Prepetition Junior Lenders and/or JLL (including, without limitation, those protections contained in that certain Stipulation and Agreed Interim Order entered by this Court on May 10, 2004, and any final order entered with respect thereto), which protections upon such revocation shall be deemed void ab initio and of no force and effect.

There is no reported decision which explains the basis for the court's order for the original "offending language" to be revised in a way that clearly reserves any disputes concerning the enforceability of the waiver provisions in the Subordination Agreement for another day. However, counsel involved in the dispute have shared that the Objections were resolved consensually. Specifically, the "offending language" and any appearance of approval of the underlying waivers or injunctive or declaratory relief was removed and replaced with reservations of rights by all. In other words, the fight was reserved for a later day.

While the *New World Pasta* case does not provide a clear answer to the question of enforceability of the types of waivers typically found in silent second liens, it is instructive in many ways. First, the Final Order was issued in July 2004 and confirms that there are no clear answers to the question at hand. Second, the objection suggests that approval of DIP financing, cash collateral, and adequate protection in bankruptcy cases involving prepetition facilities with second liens may be construed as a blessing of the underlying loan documents and the waivers they contain. The ultimate change in the language seems to imply that such a conclusion is possible and may in fact act as an estoppel against raising the issues later. Finally, the *New World Pasta* case also shows that the issue may not be resolved once and for all in a reported decision because many cases which involve enforceability of the silent second lien will be settled either on their own or as part of a larger settlement. Once a bankruptcy case is filed, time is short. As discussed above, DIP financing and cash collateral need to be in place essentially before the case is filed. In a majority of the cases, the borrower/debtor is so highly leveraged, there is no ability to wage a successful priming fight and prepetition lenders are the only game in town. Issues need to be resolved quickly and no one benefits, not the least of which the junior lenders, if precious time is lost and the borrower's money is spent on litigating these issues. Settlement is in everyone's best interest. An area where it may be worthwhile to litigate the waivers may be at plan confirmation time and the enforcement of voting waivers. However, it is likely that by the time of plan confirmation, most of the issues will have also been consensually resolved by the parties over the course of the case.

3. Payment of Post-Petition Interest to Senior Lien Holder

As noted earlier in this Article,[76] payment of post-petition interest to the senior lender can be an important issue. Due to a recent opinion issued by the First Circuit, this area has received a lot of attention. Generally, intercreditor or subordination agreements provide that senior lien holders must be paid in full prior to junior lien holders receiving any payment. Until recently, it was generally accepted that if the document contained "precise, explicit and unambiguous" language

76. *See supra* Part II.B.1.

indicating that the senior creditors would receive post-petition interest from funds which otherwise would be payable to subordinate creditors, then the so called "Rule of Explicitness" is complied with, the language will be enforced and the senior creditor can receive payments of post-petition interest. However, the recent *Bank of New England*[77] bankruptcy case appears to have nullified, at least in the First Circuit, the Rule of Explicitness and disturbed the established landscape in the name of overriding bankruptcy policy against bankruptcy specific state law.[78]

The rationale behind the Rule of Explicitness recognizes that parties may use subordination agreements to consent to payment of post-petition interest to senior creditors from funds that would otherwise go to subordinated creditors.[79] The Rule of Explicitness, as described by one court, is federal common law that seeks to protect junior noteholders from the seemingly inequitable result of allowing senior noteholders more than they would be allowed in bankruptcy, at the expense of the junior noteholders who might not have thought about this result at the time of the execution of the subordination agreement.[80] Under the Bankruptcy Code, it is established that an unsecured creditor cannot receive post-petition interest on account of its claim.[81] Accordingly, since an unsecured creditor in an insolvent case is not entitled to receive post-petition interest, courts were reluctant to allow senior creditors to receive post-petition interest from junior creditors when that interest would not have been recoverable by the senior lender from the debtor. Over time, the equitable doctrine of the Rule of Explicitness evolved so that unequivocal language in a subordination agreement could overcome the general prohibition on receiving post-petition interest.[82] Thereafter, the Rule of Explicitness paved the way to

77. *In re* Bank of New England, 364 F.3d 355 (1st Cir. 2004).

78. *See* 24 BANK. L. LETTER No. 11, 1 (November 2004).

79. *In re* Southeast Banking Corp., 93 N.Y.2d 178, 182, 688 N.Y.S.2d 484, 710 N.E.2d 1083, 1085, 34 Bankr. Ct. Dec. ((RR) 326 (1999)).

80. *See* Honor S. Heath & James J. Tancredi, *The Ingenuity of Subordinated Debt*, 18 AM. BANK. INST. J. 10, (Oct. 1999) (citing *In re* Southeast Banking, 179 F.3d 1307, 1309 (11th Cir. 1999)).

81. Congress codified the longstanding practice of disallowing post-petition interest on unsecured claims in both the 1988 Act (in § 63a(1) & (5)) and the current Bankruptcy Code (in § 502(b)(2)).

82. *See, e.g.*, *In re* Times Sales Fin. Corp., 491 F.2d 841 (3d Cir. 1974); *In re* King Resources, 385 F.Supp. 1269 (D. Co. 1974), *aff'd* 528 F.2d 789 (10th Cir. 1976); *see also*

justify the use of the bankruptcy court's equitable powers in allowing the payment of post-petition interest to senior lenders.

In an attempt to harmonize the Rule of Explicitness with the Bankruptcy Code § 510(a) requirement of enforcing subordination agreements, the Court of Appeals in New York, in *Southeast Banking*[83] stated: "New York law would require specific language in a subordination agreement to alert a junior creditor to its assumption of risk and burden of allowing the payment of senior creditor's post-petition interest demand."[84] Later, the Eleventh Circuit recognized the Rule of Explicitness in a second *Southeast Banking* case, but compared the language in the subordination agreement before it (requiring that senior notes were to paid "in full" before junior noteholders were to receive any payment) and found that the language was insufficiently precise and thus did not satisfy the requirements of the Rule of Explicitness.[85]

To understand the impact of the First Circuit's ruling, and the reasoning for the decision, an analysis of the facts in the *Bank of New England* case is necessary. The case before the First Circuit involved six separate series of debt instruments issued by the Bank of New England in the total amount of $706 million.[86] Three issues of the senior debt were entitled to contractually agreed upon subordination pursuant to provisions in the trust indentures for the three remaining issues of junior debt:

> The Company agrees that upon . . . any payment or distribution of assets of the Company . . . to creditors upon any dissolution or winding up or total or partial liquidation or reorganization of the Company, whether voluntary or involuntary or in bankruptcy, insolvency, receivership, conservatorship or other proceedings, all principal . . . and interest due or to become due upon all

Richard E. Mikels, et al., *Subordination Agreements Case Highlights Conflict with State Law*, 23 AM.BANK. INST. J. 12 (Dec./Jan. 2005).

83. *In re* Southeast Banking Corp., 179 F.3d 1307, 1309 (11th Cir. 1999), 93 N.Y. 2d 178, 182 (1999).

84. *Id.*

85. Heath, *supra* note 43; *see also* 179 F.3d at 1307.

86. *In re* Bank of England, 364 F.3d 355, 355 (1st Cir. 2004).

> Senior Indebtedness . . . shall first be paid in full . . . before any payment is made on account of the principal of or interest on the [Junior] indebtedness. . . .[87]

Later, in 1991, a Chapter 7 bankruptcy petition was filed by Bank of New England.[88] The estate took over 10 years to administer and the Chapter 7 trustee made three distributions which complied with the subordination provisions and made the payments to the senior creditors only.[89] The three distributions were for all outstanding principal plus accrued interest on senior debt to the date of the filing of the petition.[90] Thereafter, the trustee sought permission to distribute an additional $11 million to the holders of the junior debt.[91] The indenture trustees for the senior debt, however, objected, claiming that the subordination provisions attached to the junior debt required payment of post-petition interest on the senior debt before any amounts could be paid on the junior debt.[92] The accrued post-petition interest on the senior debt greatly exceeded the $11 million available for distribution.[93] Relying upon the Rule of Explicitness, though, the bankruptcy court overruled the objection of the senior debt and authorized the trustee to distribute the $11 million to the holders of the junior debt, and the district court affirmed.[94] The bankruptcy court easily found that under the Rule of Explicitness, "creditors are not entitled to post-petition interest in bankruptcy proceedings absent express language to that affect in subordination agreements ordering priorities among the contracting parties."[95] The cases have uniformly concluded that general language providing that "all principal and interest on all senior debt shall first be paid in full . . . is insufficiently express to relate to post-bankruptcy interest."[96] In the court's opinion, while subordination agreements are

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87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. 364 F.3d at 361.

92. *Id.*

93. *Id.*

94. BANKR. L. LETTER, *supra* note 78, at 2.

95. 93 N.Y.2d at 186.

96. *In re* Kingsboro Mortg. Corp., 514 F.2d 400, 401 (2d Cir. 1975); *accord In re* Southeast Banking Corp., 179 F.3d 1307, 1310, 34 Bankr. Ct. Dec. (CRR) 755, 42 Collier Bankr. Cas. 2d (MB) 639, Bankr. L. Rep. (CCH) ¶ 77953 (11th Cir. 1999) [hereinafter

uniformly acknowledged pursuant to § 510(a) of the Bankruptcy Code, proper implementation of such a subordination agreement among unsecured creditors with respect to distributions from a bankruptcy estate, however, is inevitably obscured by the principle of both English and American bankruptcy law disallowing post-petition interest on unsecured claims.[97] Accordingly, the issue was reduced to whether it is ever possible to allow the payment of post-petition interest on a unsecured claim when there is a clear provision of the federal Bankruptcy Code which prohibits such payment.

As in the *Southeast Banking* case, the applicable state law in the *Bank of New England* case was that of New York pursuant to choice of law provisions in all of the relevant debt instruments.[98] The First Circuit concluded that the only New York state law that could legitimately be incorporated by § 510(a) is bankruptcy-neutral state law.[99] Specifically, the court stated:

> One thing seems very clear: in keeping with the principle that bankruptcy is an area of distinct federal competence, Congress has conferred on the federal courts the power to apply any and all generally applicable state rules of contract interpretation in construing subordination agreements. But section 510(a) does not vest in the states any power to make bankruptcy-specific rules: the statute's clear directive for the use of applicable nonbankruptcy law leaves no

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Southeast Banking III]; Matter of King Resources Co., 528 F.2d 789, 791-92 (10th Cir. 1976) [Bankr. Serv., L Ed. § 25:386]; *In re* Time Sales Finance Corp., 491 F.2d 841, 844 (3d Cir. 1974).

97. *See* Nicholas v. U.S., 384 U.S. 678 (1996). Mr. Justice Holmes first articulated this rule as a precept of American bankruptcy law:

> For more than a century and a half the theory of the English bankrupt system has been that everything stops at a certain date. Interest was not computed beyond the date of the commission. Ex parte Bennet, 2 Atk. 577. As appears from Cooke, the rule was laid down not because of the words of the statute, but as a fundamental principle. We take our bankruptcy system from England, and we naturally assume that the fundamental principles upon which it was administered were adopted by us when we copied the system. . . . No one doubts that interest on unsecured debts stops.

Id.

98. In re Bank of England, 364 F.3d 355, 360 (1st Cir. 2004).

99. *Id.* at 365.

> room for state legislatures or state courts to create special rules pertaining strictly and solely to bankruptcy matters.[100]

According to the First Circuit, then, express adoption of the Rule of Explicitness by the New York Court of Appeals in *Southeast Banking* was essentially irrelevant because that court was fashioning an invalid bankruptcy-specific rule.[101] The First Circuit determined that the only state law which could be applied to determine whether post-petition interest was properly payable to a senior lender under a subordination agreement is applicable state law which must be "bankruptcy neutral."[102] Of particular significance is the court's holding that state laws which are created to only apply in the context of bankruptcy should be given no deference.[103] Having invalidated the New York Court of Appeals' adoption of the Rule of Explicitness, the First Circuit considered the senior debt's entitlement to post-petition interest pursuant to the terms of subordination agreement, construed in accordance with generally applicable, bankruptcy-neutral principles of contract law.[104] The court concluded that the language of the subordination agreement was ambiguous as applied to the issue of post-petition interest and, therefore, remanded "for fact-finding on the parties' intent vis-à-vis post-petition interest."[105]

Clearly, the issues surrounding the validity of Rule of Explicitness in the First Circuit and, if valid, what needs to be placed in an intercreditor agreement which will be enforced to provide for post-petition interest to be paid to senior creditors either in accordance with the Rule of Explicitness or some other "generally applicable, bankruptcy neutral principle of contract law" are far from resolved. Additionally, the *Bank of New England* case complicates matters further, and perhaps the post-petition interest issue is lost, as it slips into a dark tunnel of controversy concerning conflict of law provisions and the intersection of federal bankruptcy policy and state law.

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100. 364 F.3d at 364.
101. *Id.* at 366.
102. *Id.*
103. *Id.* at 355; *see also* Mikels, et al., *supra* note 82, at 12..
104. 364 F.3d at 366-67.
105. *Id.* at 368; *see also* Mikels, et al., *supra* note 82, at 14.

4. Voting Restrictions and Waivers

In *In re 203 North LaSalle Street Partnership*[106] a bankruptcy court was faced with an action commenced by the senior creditor to enforce a provision in the subordination agreement that stripped the junior lien holder of its right to vote on a Chapter 11 plan of reorganization.[107] The court upheld the payment subordination pursuant to the terms of the subordination agreement and specifically recognized the validity of subordination agreements pursuant to § 510 of the Bankruptcy Code.[108] However, the court determined that subordination affects only the priority of payment and that § 510(a) does not allow for a waiver of voting rights pursuant to § 1126(a) of the Bankruptcy Code.[109] Specifically, the court refused to enforce the junior creditor's prepetition waiver of its right to vote on a plan because: (i) prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code; (ii) § 510(a), in directing enforcement of subordination agreements, does not allow for a waiver of voting rights under § 1126(a) of the Bankruptcy Code; (iii) Bankruptcy Rule 3018(c) does not allow for voting of the subordinated creditor's claim by the secured creditor; and (iv) stripping a junior creditor of a right to vote is inconsistent with bankruptcy policy given the junior creditor's potential "substantial interest in the manner in which its claim is treated."[110] The court stated:

> It is generally understood that prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code. . . . Indeed, since bankruptcy is designed to produce a system of reorganization and distribution different from what would obtain under non-bankruptcy law, it would defeat the purpose of the [Bankruptcy] Code to allow parties to provide by contract that the provisions of the [Bankruptcy] Code do not apply.[111]

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106. 246 B.R. 325 (Bankr. N.D. Ill. 2000).

107. *Id.* at 328.

108. *Id.* at 325.

109. *Id.* at 327.

110. 246 B.R. at 332; *see also In re* New World Pasta Company, 2004 WL 1484987 at *5 (Limited Objection).

111. 246 B.R. at 331.

Two other cases addressing voting restrictions have reached the opposite conclusion, however. In *Inter Urban Broadcasting*,[112] a debtor, a senior creditor, and a junior creditor entered into a subordination and intercreditor agreement, pursuant to which, among other things, the junior creditor assigned and subordinated its claims, rights and collateral to the senior creditor until the senior creditor was paid in full.[113] Part of the proceeds from the loan from the senior creditor were used to pay down the obligation secured by the junior loan.[114] In the subsequent bankruptcy, the senior creditor tendered a competing plan which essentially provided for the senior creditor to receive partial repayment and the junior creditor to receive nothing.[115] The senior creditor voted in favor of its plan on behalf of itself and the junior creditor, and the debtor objected.[116] The bankruptcy court denied confirmation of the debtor's plan and confirmed the senior secured creditor's plan.[117] The debtor appealed to the district court.[118] The district court noted that the junior creditor benefited from the senior loan and that no one had established that the agreement could not be enforced.[119] Accordingly, the court upheld the intercreditor agreement and held the senior creditor's vote on behalf of itself and the junior creditor was "proper and in accordance with the law."[120]

In a case that pre-dates both *LaSalle* and *Urban Broadcasting*, the Bankruptcy Court for the Eastern District of Pennsylvania dealt with voting issues as well as more broadly with intercreditor agreements.[121] Pursuant to a separate agreement, the bank senior lender agreed to be subordinate to the senior working capital lender.[122] The borrower defaulted, filed a petition for relief under Chapter 11 of the Bankruptcy Code, and sought to have a plan confirmed pursuant to which it had separately classified the senior and junior lien holders.[123] The junior

112. *In re* Inter Urban Broadcasting, 1994 WL 646176 (E.D. La. 1994).
113. *Id.*
114. *Id.* at *2
115. *Id.* at *1-2.
116. *Id.*
117. *Id.* at *1.
118. *In re* Inter Urban Broadcasting, 1994 WL 646176 (E.D. La. 1994).
119. *Id.* at *2.
120. *Id.*
121. *In re* Curtis Center Ltd. P'Ship., 192 B.R. 648 (Bankr. E.D. Pa. 1996).
122. *Id.* at 651.
123. *Id.* at 655-56.

lien holder (the bank senior lender) voted in favor of the plan.[124] The senior working capital lender objected noting that the junior lien holder had no right to vote for or against the plan pursuant to the restrictions in the intercreditor agreement.[125] The court noted that the senior lender had made it clear during the case that, pursuant to the subordination agreement, it had the right to vote the junior lender's claim, and, as such, the plan could not possibly be confirmed.[126] The court held that the unambiguous language of the subordination agreement was enforceable and that the debtor could not rely on the junior lien holder's acceptance of the plan to satisfy the requirement of receiving an acceptance by an impaired class for purposes of "cramdown" pursuant to § 1129(a)(10) of the Bankruptcy Code.[127]

5. Proofs of Claim

As part of a silent second lien arrangement, it is common to provide in the intercreditor agreement that a senior creditor can file a proof of claim on behalf of a junior lien holder. In *Davis Broadcasting*[128] two creditors of the debtor had entered into a "Continuing Subordination and Pledge Agreement" which gave the senior creditor superior lien rights over the junior creditor as well as granted the senior creditor additional rights in the case of default and/or future bankruptcy.[129] More specifically, the senior creditor was granted the right to file a proof of claim and vote in the event of a bankruptcy proceeding.[130] A bankruptcy was filed, the senior creditor filed the proof of claim and voted on its and the junior creditor's behalf in favor of the Chapter 11 plan.[131] The junior creditor did not object and a substantial consummation order was entered.[132] Over a year later, the junior creditor petitioned the court to reopen the case to correct what it

124. *Id.* at 659-60.
125. *Id.* at 660.
126. *Id.*
127. *In re* Curtis Center Ltd. P'Ship., 192 B.R. 648 (Bankr. E.D. Pa. 1996).
128. *In re* Davis Broadcasting, Inc. 169 B.R. 229 (Bankr. M.D. Ga. 1994).
129. *Id.* at 230.
130. *Id.* at 231.
131. *Id.*
132. *Id.*

called an "error" in the confirmation process.[133] The bankruptcy court rejected the junior creditor's motion and essentially enforced the Subordination and Pledge Agreement as written, nothing that the junior creditor had freely entered into the subordination agreement.[134]

C. *Practical Suggestions to Address Enforceability Concerns*

The cases examined in this Article establish that bankruptcy courts definitely acknowledge and will enforce subordination agreements pursuant to § 510 of the Bankruptcy Code to the extent that such subordination provisions relate to payment and priority of payment. When it comes to the enforcement of subordination agreements in the nature of waivers of voting rights, ability to file a proof of claim, receive adequate protection and other similar waivers and restrictions on the rights of junior lenders, courts have issued differing opinions. The following suggestions are a few which may help in receiving a finding from a bankruptcy court enforcing certain waiver provisions.

As to the payment of post-petition interest, senior creditors would be wise to carefully craft language that is "precise, explicit and unambiguous" making it clear to junior noteholders that their payment of the senior creditors' interest may entitle the senior creditors to receive more in a bankruptcy case than the Bankruptcy Code will allow. Even if the Rule of Explicitness is not recognized by a court, if the language is sufficient to create a right to receive the payment under bankruptcy neutral applicable state contract law, then the standard may be met. The suggestion from the *Bank of New England* court that the language must meet bankruptcy neutral applicable state law provides nothing more than a murky standard for which no clear direction has been established. Frankly, if a court in the First Circuit, or other court deciding to adopt the *Bank of New England* rationale, accepts that because the Rule of Explicitness conflicts with a bankruptcy policy against the payment of post-petition interest to a senior lender when it would not have been entitled to receive it from the debtors, it is hard to imagine how any language could clear the established bar. For now, in

133. *Id.*
134. *In re* Davis Broadcasting, Inc. 169 B.R. 229, 235 (Bankr. M.D. Ga. 1994).

the First Circuit, lenders still have much to be concerned about. In all other circuits, until decisions are issued, lenders should continue to be as precise as possible in all language concerning the payment of post-petition interest, the circumstances of the payment and explain exactly what the junior lien holder is agreeing to in the intercreditor agreement. Additionally, any language clearly spelling out the intent of the parties with respect to the payment of post-petition interest could be helpful.

As to voting waivers, the *LaSalle* court and others clearly state that § 1126 rights under the Bankruptcy Code cannot be contracted away. However, the *Davis* and *Urban Broadcasting* courts seem to recognize the sophistication of the parties and the enforceability of waivers of voting rights. One possible way to address the decision in *LaSalle* is to make sure that the provisions in the intercreditor agreement concerning voting are sufficient to create an agency relationship between the junior and senior secured lenders rather than a transfer of waiver of voting rights.[135] If the senior lender is an agent to vote the claim of the junior lender then the issue of altering § 1126 rights might not be an issue. Additionally, Federal Rule of Bankruptcy Procedure 3018(c) specifically provides that an acceptance or rejection of a Chapter 11 plan must be by "the creditor . . . or authorized agent." A note of caution, however. The *LaSalle* court specifically discussed the application of Rule 3018(c) and concluded that, because an "agent" is understood to act at the direction of the principal, and because in the *LaSalle* case the senior creditor would be acting in its own interest, the senior creditor could not vote the junior creditor's claim as its agent. The question is left open, however, if a different result is warranted when a direct agency relationship is established by contract rather than seeking a determination by the court that an agency relationship is created based on conduct.

As to waivers not involving voting rights, given the implication of the *New World Pasta* case, careful attention should be paid at the time of the approval of DIP financing, cash collateral, and adequate protection orders. Depending upon which constituency counsel is advocating for, objections and global reservations of rights (similar to those in the *New World Pasta* Final Order) may be appropriate.

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135. *See* Bruce H. White & William L. Medford, *Subordination Agreements and Voting Right: Will Your Intercreditor Agreement be Enforced?* 20 AM. BANKR. INST. J. 32 (Jul./Aug. 2001).

IV. CONCLUSION

There is much about the enforcement of many commonly included provisions in the subordination documentation for silent second lien loans which remains unclear. While there is some case law which addresses the enforceability of agreements for the subordination of payment and priority of payment, which can be applied by analogy, there is still no absolute direction and precedent. It is clear, however, that the second lien market is one which can benefit lenders and borrowers alike, and one which appears will remain part of the lending landscape for quite some time. First lien holders would be wise to address some of the suggested drafting issues noted herein and to fully understand the risks associated with the possible inability to enforce all of the "silence" provisions generally included in the second lien loan documentation. Second lien holders really have nothing to lose because, in the end, they may find themselves in a stronger position than originally bargained for. Borrowers also do not have too much to be concerned about since, for now anyway, they can enjoy the greater availability of financing options available to them, as well as the more favorable pricing (as compared to unsecured debt) which is associated with second lien financings.